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MAJOR INSTITUTIONAL REQUIREMENTS FOR SUCCESSFUL ECONOMIC DEVELOPMENT*

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I

Let me begin this paper with a quote from an article published in the *Rhodesian Journal of Economics*: "If one assumes an incremental capital-output ratio for Rhodesia of the order of 3 : 1 and a desired rate of economic growth of six per cent per annum this would mean a desired rate of net investment of no less than 18 per cent of GDP."[1] This statement, which is based on the Harrod-Domar model of growth, reflects all the properties of modern growth theories such as elegance, quantifiability and deterministic solution. Yet, it seems to be a historical fact that countries least concerned with the implementations of modern growth models have done as well if not better for their people as those countries which have embarked upon various planning schemes.

In this paper I will argue that to consider the saving-investment relationship as a major determinant of the rate of growth, and an increase in the supply of investible funds as a major determinant of the increase in the rate of growth is at best misleading and at worst nonsensical. For faster rate of growth of wealth is achieved not merely by increased saving but by more effective institutions for organizing, co-ordinating and directing productive activity.

II

Taking the static analytical concepts of Keynes as their point of departure, Harrod, Hicks and others have developed a number of dynamic growth models. The common denominator of all those models is that the saving-investment relationship is taken as the primary endogenous source of economic growth. The structure of the economy, that is technology and organizational framework, is assumed either constant or changing at some postulated rate. Hicks, for example, got his model moving by assuming an innovation.[2] Yet he analysed the economic process by postulating that changes in technology and organization are external to the working of the economic system, and thus fall outside the scope of economic analysis. In other words, modern growth theories which have evolved from the basic Keynesian model consider increases in the supply of investible funds at the expense of current consumption as the major source of larger social dividend. Thus, there is nothing wrong, and in fact it is desirable, to supplement private investment by tax-financed governmental expenditures

1. A. M. Hawkins, "The Rhodesian Economy Under Sanctions", *Rhodesian Journal of Economics*, Vol. 1, No. 1, p. 58.
2. J. Hicks, *A Contribution to the Theory of the Trade Cycle* (London: Oxford University Press, 1961).

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whenever private wealth owners fail to save and invest "enough". The policy of extracting forced saving from the community may have the counter-effect of a possible fall in the rate of saving out of the reduced disposable income; it may also result in the use of private savings to create goods that yield more nonpecuniary income. These considerations are somehow missing from modern growth models.

Yet, the major reason for failure of Harrod-Domar types of growth models is their incompleteness. This incompleteness arises from their neglect to recognize that economic activity involves a double variation:[1] variations in the quantity of inputs which they recognize, and variations in the quality of inputs which they do not. The latter means a technological or organizational innovation or, what is the same thing, a change in the index of significance of inputs relative to output.

It is not too difficult to understand why the act of innovation is presumed to fall outside the scope of economic analysis by modern growth theorists. Innovation can be neither planned nor predicted in advance. Moreover, innovations occur in clusters rather than at random. Thus, a growth model which would consider innovation as a nendogenous variable would be, by definition, an indeterministic one. The model builder, searching for a fashionable deterministic solution, has no choice, and the economic planner in fact finds it in his own self-interest, to assume away such an uncontrollable variable as innovation. Baumol, for one, said that the type of analysis presented by Schumpeter does not appeal to him because he failed to build a deterministic system.[2]

It is important, however, to recognize the major difference between the quantitative and qualitative economic change. The former leads to an increase in national output *via* a sacrifice of current consumption, while the latter means an increase in the community's welfare *via* more efficient use of resources. Thus, it is the act of innovation which makes a true contribution to economic development. It follows that the major problem of economic development is to maximize the flow of innovation. And since innovation can be neither planned nor predicted the major problem of economic development boils down to creating the environment conducive for carrying out innovating activities.

III

The major requirements for creating the environment conducive for carrying out innovating activities are: freedom to innovate, the availability of economic power to innovate and a system of sufficient incentives.[3] The question is what are some most important institutions which the community should endeavour to strengthen in order to satisfy these three major requirements.

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1. To the best of my knowledge Schumpeter was the first economist to explicitly incorporate both variations into his theory of development. See J. Schumpeter, *The Theory of Economic Development* (Cambridge: Harvard University Press, 1959).
2. W. Baumol, Economic Dynamics (New York, Macmillan Co., 1951), p. 35.
3. See S. Pejovich, *The Market-Planned Economy of Yugoslavia* (Minneapolis: University of Minnesota Press, 1966), Chapter V.

Freedom to innovate is defined as the freedom to change the allocation of resources according to the innovator's vision. The act of innovation means an introduction of novelty into the flow of economic life. Thus, it presupposes a contractual agreement which gives the innovator command over some resources. It follows that the conditions governing the freedom of contractual agreements determine the freedom to innovate.

Consider an agreement between two parties to exchange goods and services (including labour, of course). It must be presumed that at least one party of the contract expects to be better off, to reach a higher indifference curve so to speak, after the contract is executed than before. Otherwise one or both of them would not accept the deal. If a voluntary contract were expected to improve the economic welfare of both parties to the contract, or of one of them leaving the other as well off as before, an increase in the extent of contractual activities would lead to an improvement in the community's welfare.

Whenever we enter into a voluntary exchange (when we sell our labour for wages or buy a pair of shoes in a store) we exchange some property rights. In fact, every commercial contract means an exchange of some bundle of private property rights, and thus it presupposes the existence of those rights. It follows that the greater the scope of private property rights the more contracts could be reasonably expected.

The basic elements of private property rights are *exclusivity* of right of use and *voluntary transferability* of that right. No person can transfer to another person more rights to a thing than he himself possesses. Thus any reduction in the extent of private property rights must be reflected in a reduction of contractual activity. Let me mention three examples.

The economist would usually say that a minimum wage law eliminates some people from the labour force. He could also say, and I think it would be a better way of saying it, that a minimum wage law attenuates our property rights over our own labour by forbidding us to transfer it to the employer below a certain price. Consequently, it prevents some people from entering into contractual agreements with their prospective employers, i.e. it prevents them from seeking the most preferred position. My second example should be familiar to a university professor. Assume that two departments have different indifference ratios between secretaries and space. They could both reach a higher indifference curve *via* exchange. Yet, they are, as a rule, unable to enter into a mutually advantageous contract because they do not have private property rights over the funds allocated for secretarial help and space. Finally, unwillingness or expectations about unwillingness of the state to strengthen private property rights would make people fearful of theft of the wealth they accumulate and force them into a type of behaviour—accumulation of gold, diamonds, etc. —which reduces the scope of contractual activity.

These three examples indicate that the attenuation of private property rights, the absence of private property rights and expectations about the weakening of private property rights reduce the extent of contractual agreements in a community, thus preventing its members from reaching the most preferred position. It follows that the freedom to innovate, that

is the possibility of acquiring and using resources in accordance with the innovator's vision depend on the scope of private property rights.

The availability of economic power is the second factor influencing economic development. The freedom of the innovator to enter into contractual agreements which provide him with command over scarce resources and his freedom to use them in accordance with his vision are futile without the economic power whereby those resources could be acquired.

For Schumpeter, who based his whole theory of development on the concept of economic power, this power meant a source of energy within the economic system which disrupts any equilibrium that might be attained and provide us with a purely economic theory of economic change. It could be argued that the economic power of Schumpeter is merely the old concept of purchasing power. Yet, the qualitative difference between the two concepts exists. Physically, it could be the same sum of money. In Schumpeter's scheme, however, it is not a medium of exchange which equalizes marginal costs and utilities and moves the system towards an equilibrium. It is the source of energy which disrupts the equilibrium relationships and becomes the engine of the qualitative economic change; the act of innovation being an injection of novelty into the flow of economic life it aims at the satisfaction of wants whose marginal utilities are not known and can be only anticipated.

It follows that the more readily is the economic power available to the innovator the easier it would be for him to implement his ideas. The well developed banking system willing and able to extend credit appears to be a must.

The third requirement of economic development is the system of incentives. The act of innovation being a non-routine action entails a relatively high degree of risk and uncertainty about its outcome. And why should one try to implement his ideas and break the established equilibrium relationships unless he is given sufficient incentives for the risk he takes? And to be given sufficient incentives it must mean that the innovator must be assured of his right to appropriate the gains from innovation. Once again it suggests the importance of private property rights for successful economic development. While our modern theories of growth seems to neglect this point the economists in Eastern Europe, thanks to their experience with planning I guess, are becoming fully aware of it. Recently, a leading Yugoslav economist wrote: "If one wants to expand and improve entrepreneurial activity, one cannot avoid the flow of entrepreneurial product of entrepreneurs, whoever they may be . . . one cannot negate the economic necessity that entrepreneurs be proprietors of their products . . . entrepreneurial activity . . . is merely a special kind of work which it is necessary to supply in adequate quantities and quality of production . . . entrepreneurial incurves can never be regarded as state or society incurves. . . . I would not be surprised, therefore, if somewhere

in the future this will find its expression in giving enterprises property rights in their means of production."[1]

IV

Without denying the importance of growth instruments such as fiscal and monetary policies, and propensities to save and investment, this paper has attempted to explore the contribution which some institutions can make to creating the environment conducive for innovating activities. The conclusions reached are twofold: (1) the institutions of private property and modern banking system are of utmost importance for successful economic development; and (2) modern growth models fail in practice because their implementation leads to the attenuation of private property rights and thus result in a reduction in the scope of contractual activity.

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1. A. Bajt, "Property in Capital and in the Means of Production in Socialist Economies", *Journal of Law and Economics*, April, 1968, pp. 1-5.